

**Comments on  
Fiscal Policy and Financial  
Stability**

**by**

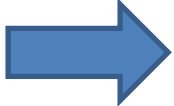
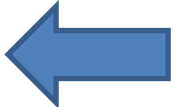
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# Structure of paper

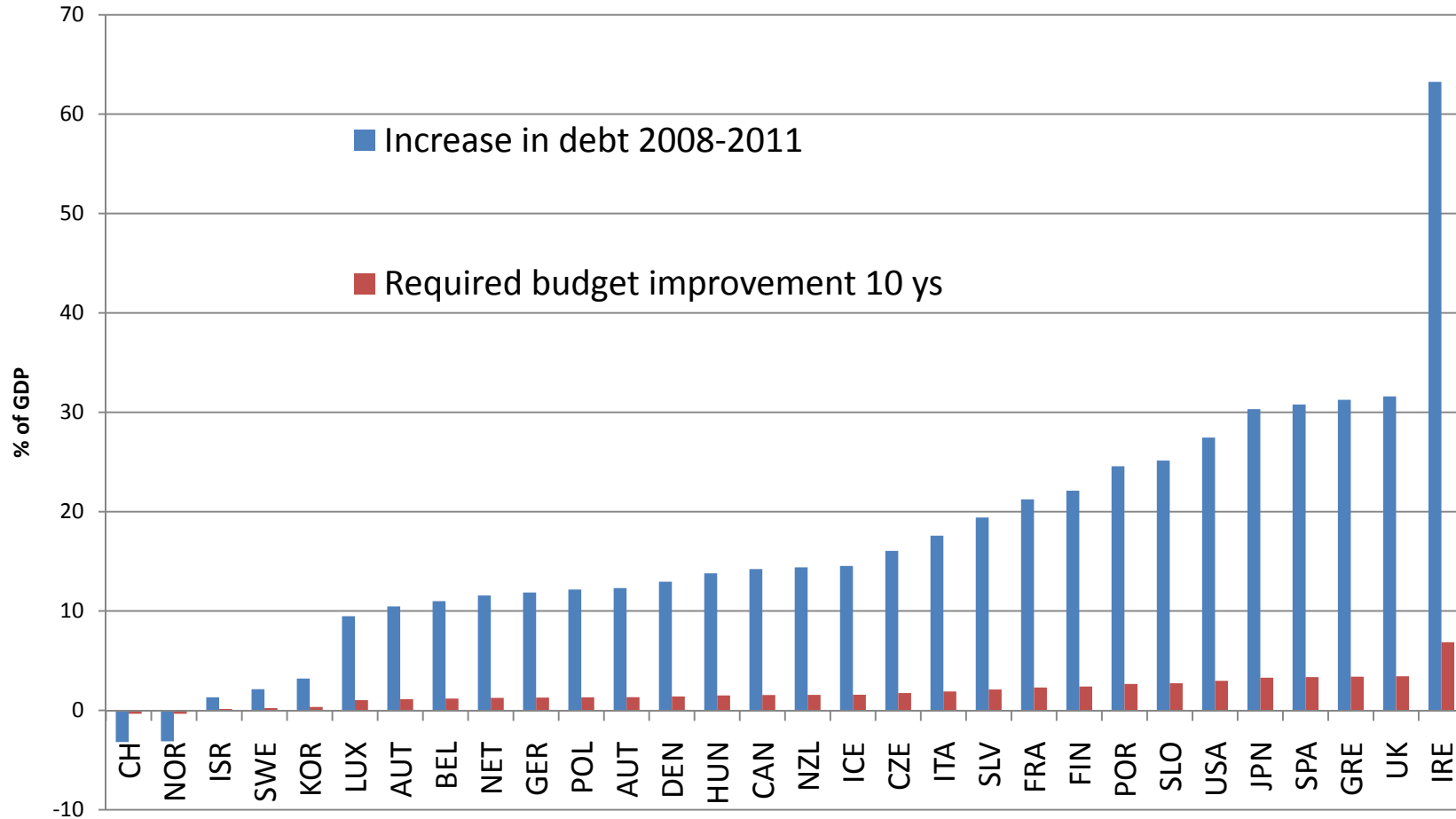
- **Inter-connections: financial stability and fiscal policy**
- **Impact of financial boom-bust cycle on fiscal policy (pro-cyclical bias)**
- **Policy implications**
  - **Crisis-prevention**
  - **Crisis handling**

- **Financial crisis**  **Fiscal crisis**
  - Budget effects (lower activity, discretionary policy)
  - Support to financial sector
- **Financial crisis**  **Fiscal crisis**
  - Cost of capital effect (return, credit standards)
  - Balance sheet effects
  - Fiscal consequences (direct and indirect)

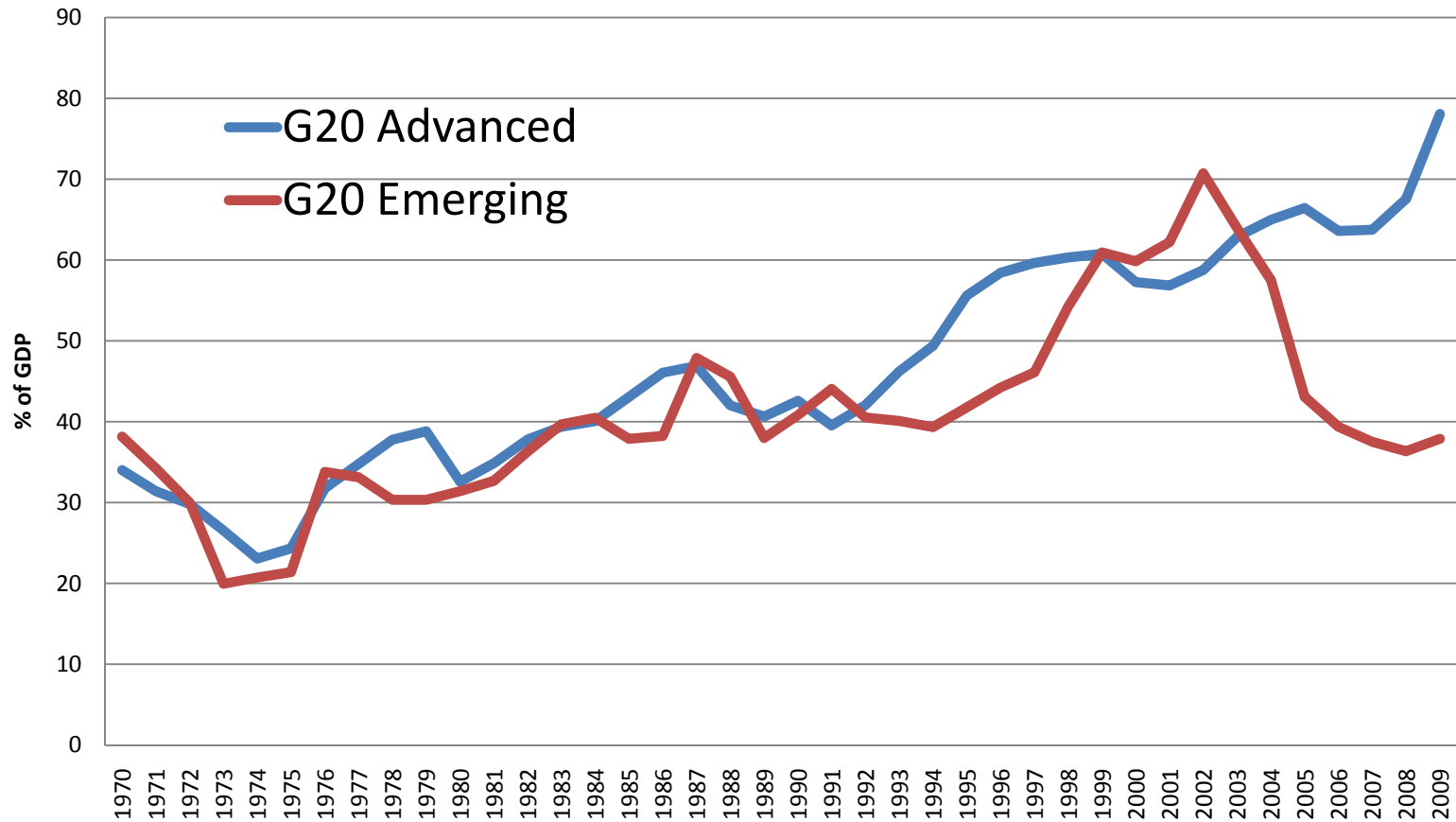
# Fiscal consequences of the financial crisis

- **Size of shock vs underlying fiscal position**
  - For most countries the shock is sizeable, but manageable
  - **BUT** it comes on top of public finance problems
- **Sustainability problem**
  - **Backward problem: only weak consolidation in years preceding crisis**
  - **Forward problem: demographic changes**

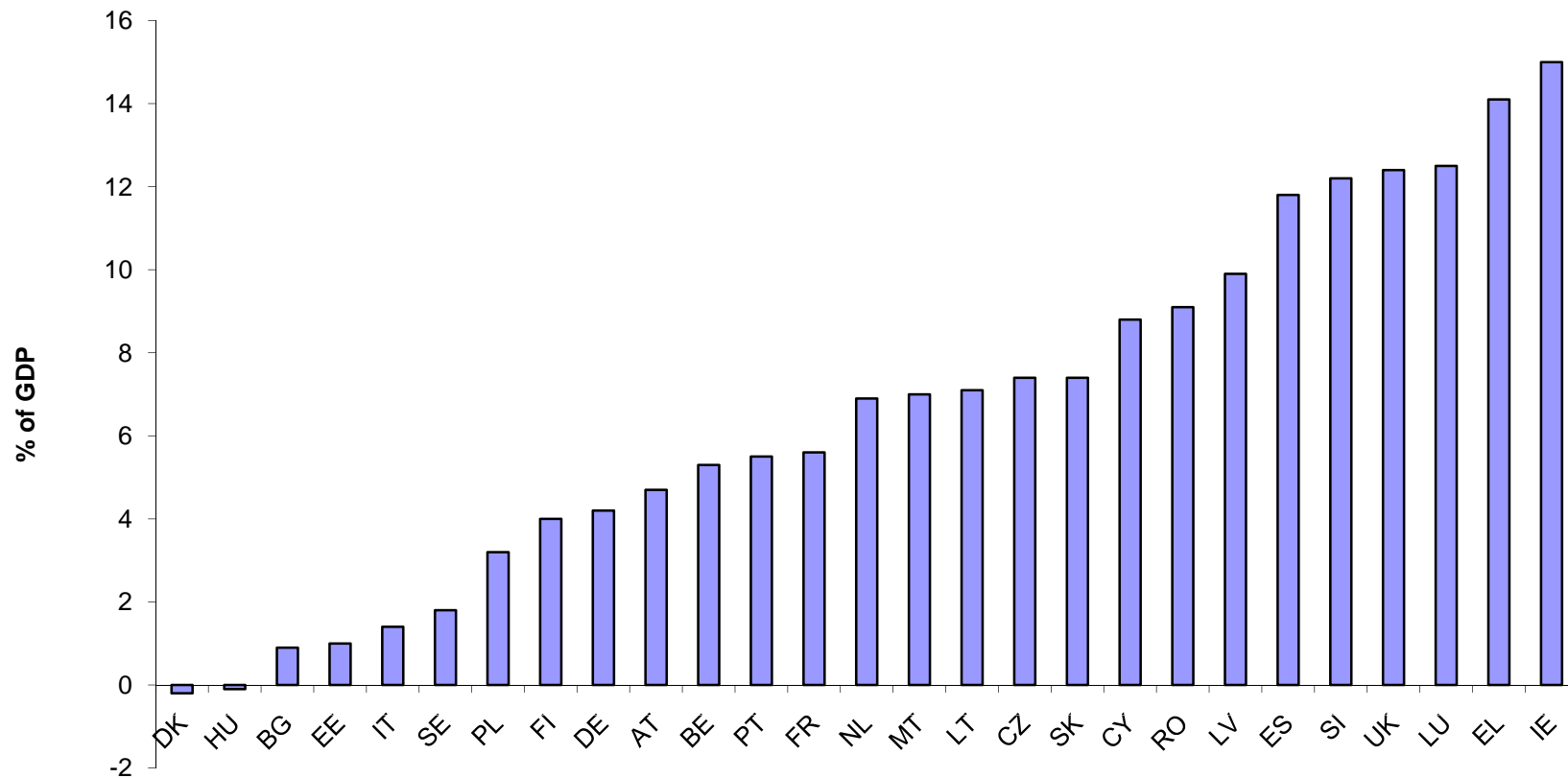
# Debt increase and fiscal adjustment



# Public debt, % of GDP, 1970-2009



# Sustainability indicator (S2): Required permanent budget improvements to meet intertemporal budget constraint EU countries



# Why this situation?

- Policy failure and/or market failure?
- Why no stronger market response prior to crisis?
- Why didn't markets enforce discipline?
- Market responses
  - Ex ante: no signals
  - Ex post:
    - Differentiated
    - Excessive?



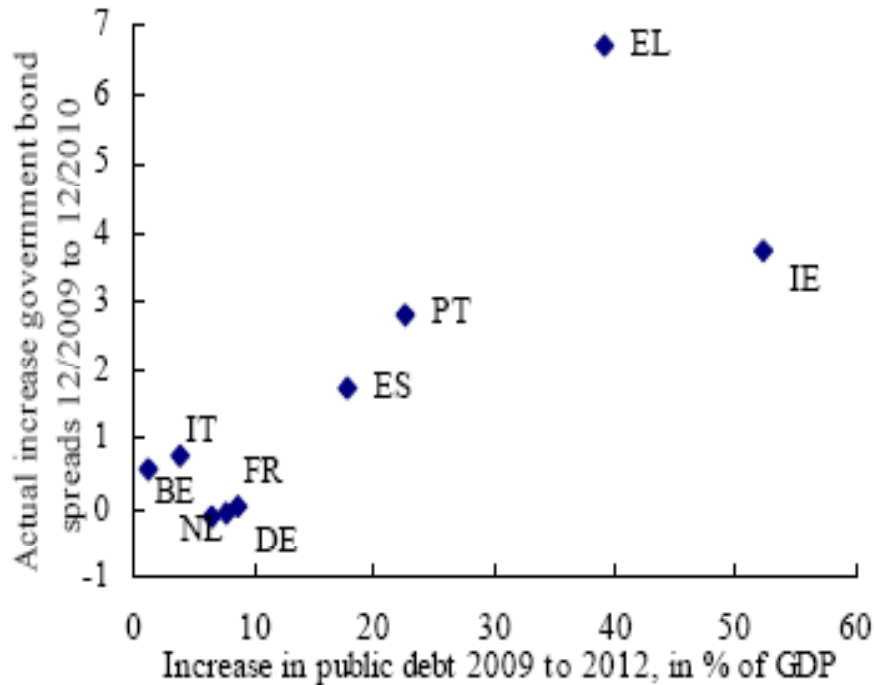


# Why this path?

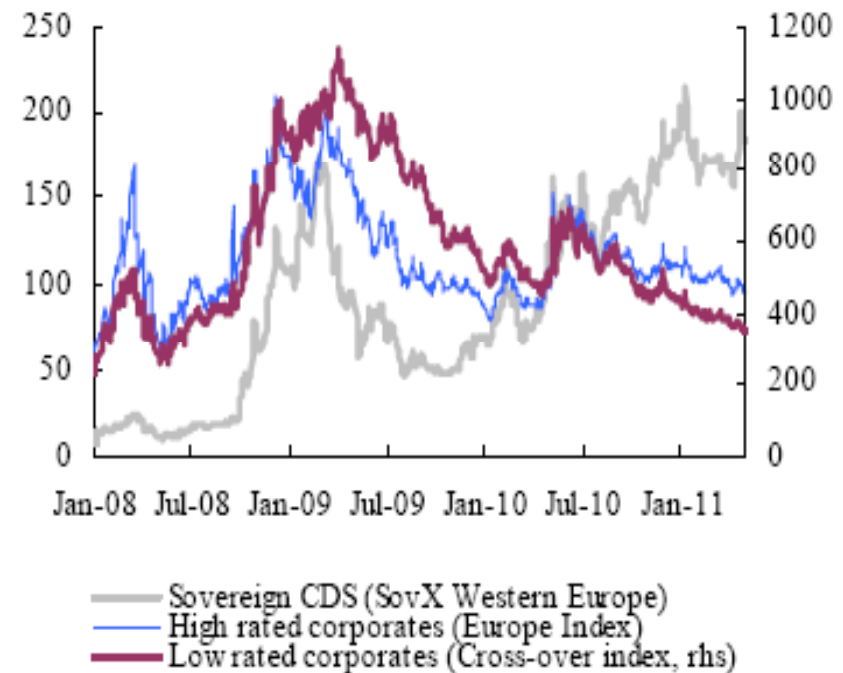
- **Critical debt level passed? (non – linearity)**
- **Higher risk aversion/price of risk**
- **Realisation of an ex-ante low probability events (tail risk)**
- **Market failures**

# Ex post – differentiated market response

Change in interest-rate spreads and the debt-GDP ratios across EURO-countries



CDS spread of sovereign and corporate debt



# Fiscal policy and financial stability

- **Fiscal policy bias**
  - Reinforces both booms and busts
  - Can be the source of multiple equilibria
- **Empirical analysis**
  - Effect of current account and credit on fiscal policy (budget balance)
- Does a positive budget effect reflect a pro-cyclical bias?
- Effect on policy (discretionary)?
- If extra revenue is spent, the budget balance is unaffected
- Weak effects on revenues and expenditures when estimated separately

# Pro-cyclical bias in fiscal policy

- **Cyclically adjusted budget balance (structural budget balance)**
  - Important guide for fiscal policy
  - Measure of discretionary fiscal policy
- **Method used is biased in direction of procyclicality and excess volatility**

# Cyclically adjusted budget-balance

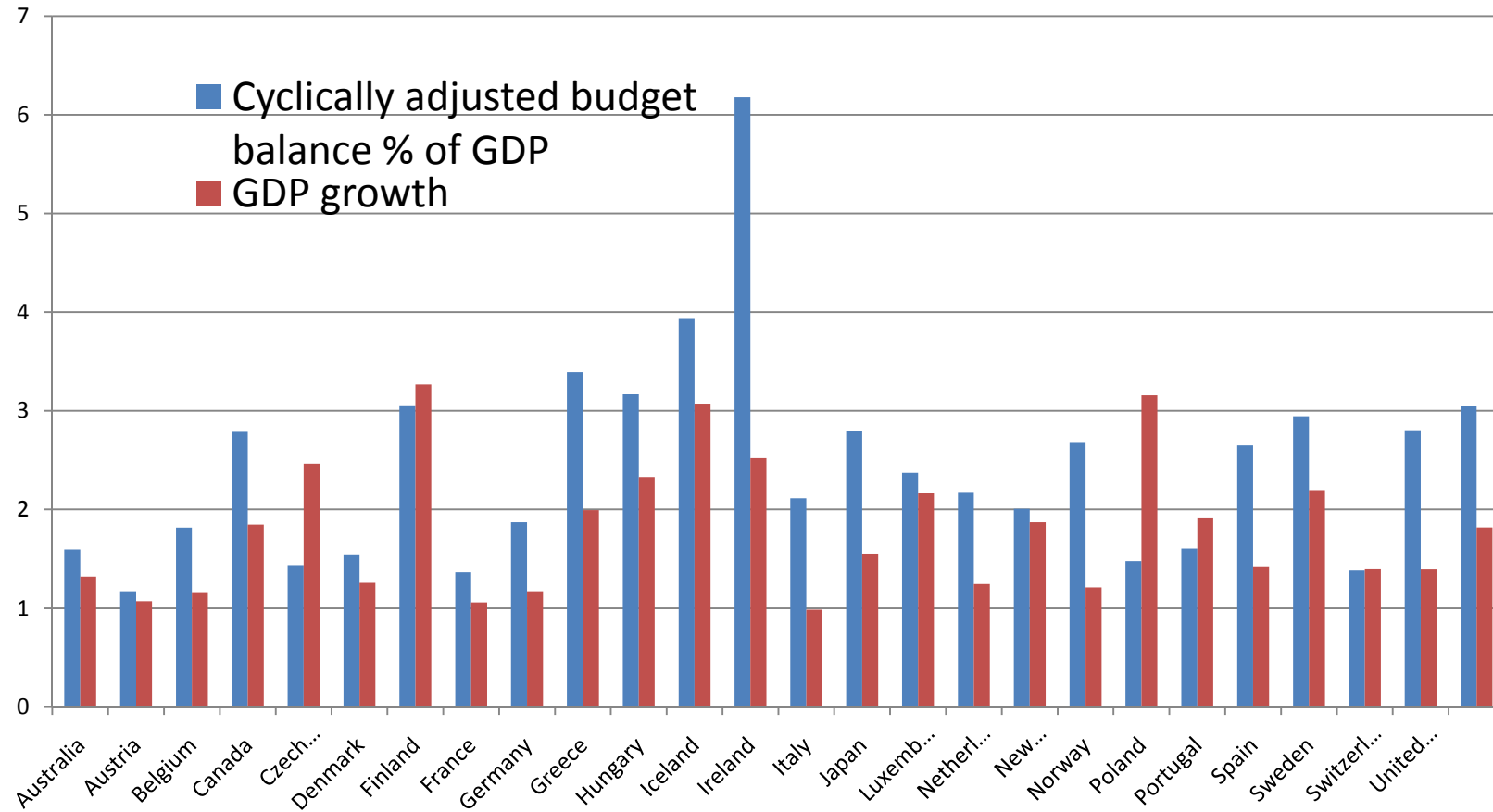
- Residual method:

$$\begin{aligned} \text{Cyclically-adjusted balance} = & \quad \text{Actual balance} \\ & - \text{Cyclical component} \\ & - \text{One-off items} \end{aligned}$$

- Noise, errors and temporary changes are taken to be changes in the structural budget position – poor guide for policy planning
- Actual measures: large variability > growth variability
- Structural measure (low frequency) – hard to reconcile with such a large level of variability

# High volatility of measures of cyclically-adjusted budget balance

## Standard deviation 1990-2010



# Policy issues

- **Policy targets**
  - Financial imbalances, credit booms
  - Current account
  - Competitiveness/real exchange rate (euro-plus pact)
- **Fiscal policy**
  - Sustainable long-term position
  - Timing, lags
  - Political distortions
- **Formal fiscal framework**
  - Targets (structural balance over the cycle)